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IN THE SUPREME COURT
OF THE UNITED STATES

74-144

JAMES T. COX, PETITIONER,

vs.

UNITED STATES OF AMERICA.

PETITION OF JAMES T. COX FOR WRIT OF CERTIORARI TO THE SUPREME COURT OF THE UNITED STATES OF AMERICA

Mary Frances Brown
Boyd L. Warner

Attorneys for
Petitioner

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IN THE SUPREME COURT
OF THE UNITED STATES

JAMES T. COX, PETITIONER,

vs.

UNITED STATES OF AMERICA.

PETITION FOR WRIT OF CERTIORARI OF THE SUPREME COURT OF THE UNITED STATES OF AMERICA

TO THE HONORABLE CHIEF JUSTICE AND ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

Your petitioner, James T. Cox, respectfully submits his petition for a writ of certiorari to review the order of the United States Court of Appeals for the Fourth Circuit decided in the above-styled case on May 22, 1974, reversing the prior decision of the United States District Court for the Northern District of West Virginia.

A. OFFICIAL AND UNOFFICIAL REPORTS

The official report of the United States Court of Appeals for the Fourth Circuit is cited as Cox vs. United States ____ F. 2d ____ (1974). The decision of the United States District Court for the Northern District of West Virginia is cited as Cox vs. United States

358 F. Supp. 798 (1973 N.D. W. Va.).

B. JURISDICTION TO REVIEW

28 U.S.C. Sec. 1254 (1) (1948), provides for the review by the Supreme Court by Writ of Certiorari granted upon Petition of any party to any civil or criminal action before or after the rendition of judgment or decree in a Federal action.

The date of judgment or decree sought to be reviewed is the final order of the District Court dismissing plaintiff's action entered on June 14, 1974, which entry of judgment was made under the direction of the United States Court of Appeals for the Fourth Circuit decided on May 22, 1974.

There has not been a petition for rehearing filed and there has not been an order granting an extension of time within which to petition for certiorari.

C. QUESTION PRESENTED

Petitioner conveyed all but a fractional interest in oil and gas leases for a lump sum payment. The leases were held for a period of more than a six month period. The question is whether the lump sum payment received from said conveyance was taxable as capital gains, as the District Court held, or as ordinary income taxable subject to depletion allowance, as the Fourth Circuit Court held.

D. STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are as follows:

Int. Rev. Code of 1954, Sec. 611 (a):

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION

(a) General Rule -- In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. For purposes of this part, the term "mines" includes deposits of waste or residue, the extraction of ores or minerals from which is treated as mining under section 613 (c). In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.

* * *

Int. Rev. Code of 1954, Sec. 1222 (3):

Sec. 1222. OTHER TERMS RELATING TO CAPITAL GAINS AND LOSSES

(3) Long-term Capital Gain -- The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income.

* * *

Treas. Reg. Sec. 1.611-1 (b) (19__):

SEC. 1.611-1. ALLOWANCE OF DEDUCTION FOR DEPLETION

(b) Economic interest -- (1) Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits or standing timber. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. For an exception in the case of certain mineral production payments, see section 636 and the regulations thereunder. A person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possesses a mere economic or pecuniary advantage derived from production. For example, an agreement between the owner of an economic interest and another entitling the latter to purchase or process the product upon production or entitling the latter to compensation for extraction or cutting does not convey a depletable economic

interest. Further, depletion deductions with respect to an economic interest of a corporation are allowed to the corporation and not to its shareholders.

* * *

E. STATEMENT OF THE CASE

This appeal involves income taxes for the taxable years 1963 and 1964 in the respective amounts of $12,156.17 and $5,556.63, plus interest.

Every material fact was stipulated by the parties in a pre-trial conference order and submitted to the District Court on briefs and argument.

The material facts as stipulated are in part as follows:

In 1959, one A. T. Carr of Chesterville, Ohio, leased 1,194 acres of oil and gas in New Milton and Cove Districts, Doddridge County, West Virginia. At the time the leases were taken up, the land leased did not have any producing wells on it. Several adjoining tracts had only marginal production.

Mr. A. T. Carr's expense in securing the leases was $1,194.00 or $1.00 per acre. Each lease had a provision that a $1.00 per acre per year would be paid as delay rental.

Mr. Carr decided to try and drill one of the leases and asked taxpayer, J. T. Cox, to share in the drilling expense and to take a half interest in the leases.

This plaintiff did.

The leasehold drilled by Carr and plaintiff was a financial failure. However, in 1962, an independent developer drilled a lease adjacent to the leases of the Cox and Carr partnership, which created a general interest in all leases located in the area. At this point the Cox and Carr partnership had $4,776.00 invested in these leases.

In 1963 and 1964, the Cox and Carr partnership assigned substantially all of their leasehold estates to various individuals for $295,125.00, with the plaintiff receiving one-half. The Cox and Carr partnership had invested in the leases assigned $7,164.00.

At the time the assignments were made, the Cox and Carr partnership did not know the amount of oil and gas reserve underlying said leases and did not have any way of determining the amount of production under each lease. At the time of the assignment there were no producing wells on any of the leasehold estates that they held. The sale price received for the leases was simply the highest and best price they could obtain at the time.

In each assignment the Cox and Carr partnership reserved a 1/16 overriding royalty interest of the 7/8 working interest in the leasehold estate. (There are some variances which are spelled out in the Pre-Trial Conference Order. However, for the purposes of this discussion, they do not appear significant.)

The interest owned by taxpayer was

therefore a 1/32 overriding royalty interest of the 7/8 working interest in the leasehold estate.

Each assignment had the following characteristics:

1. Each contained words of grant, sell, convey, assign, transfer and set over.

2. No possibility of reverter was retained by the assignor. Whatever interest the assignor owned was assigned outright except for the fractional interest reserved mentioned above.

3. None of the assignments had a provision requiring the assignee to develop.

By stipulation it was agreed that if local oil and gas developers were called, they would testify that if a bonus for the execution of a lease was paid in Doddridge County, West Virginia, the normal custom at the time the leases were assigned, would be to pay only $1.00 per acre for the execution of the leases, and by stipulation it was agreed that if Mr. Cox and Mr. Carr were to testify, they would testify that it was the intention of the partnership to sell the leases and retain a fractional overriding royalty interest. The leases assigned by the Cox-Carr partnership involved in this action were held more than six months by the partnership prior to each assignment. It is also agreed that each lease involved here is a capital asset.

The partnership received in 1963 and 1964, as proceeds from these assignments, the respective amounts of $180,125 and $115,000, which the partners divided evenly. Taxpayer on his 1963 and 1964 income tax returns reported his share of the payments as taxable at capital gains rates. The Commissioner ruled that such income was taxable to the taxpayer as depletable ordinary income and, accordingly, assessed deficiencies as to both years. The taxpayer paid the assessed amounts, filed a claim for refund (which was disallowed by the Commissioner) and instituted this suit for a refund of the amount paid. The District Court held in favor of the taxpayer, and the Government appeals.

F. FEDERAL QUESTION RAISED

This action is a tax case which originated in the District Court for the Northern District of West Virginia, and does not involve the review of the judgment of a state court. The Federal question raised is whether the money received by taxpayer from sale of his interest in the leases was taxable as capital gain or subject to depletion.

G. FEDERAL JURISDICTION

The original jurisdiction of the United States District Court for the Northern District of West Virginia was invoked under title 28, U.S.C., Section 1346 (a), which section authorizes action to recover Internal Revenue Taxes improperly assessed and paid by a taxpayer James T. Cox.

H. WHY WRIT SHOULD BE GRANTED

The writ of certiorari should be granted for the following reasons:

(a) The United States Circuit Court of Appeals are in conflict. The position maintained by the Internal Revenue Service is that if the taxpayer sells any interest in a capital asset whether it be oil and gas, or oil and gas lease, and retains any interest in the oil and gas itself, or in the production from the oil and gas lease, then under the Economic Interest Rule, this mere retention is enough to convert the sale from capital gains treatment to the status of a lease with the taxpayer receiving not cash from the sale but advanced royalty payments known as bonuses. With this conclusion the Fourth Circuit Court of Appeals agreed. However, in the case of Commissioner v. Remer, 260 F. 2d 337 (8 Cir. 1958). The eighth circuit came to a different conclusion. In the Remer case the court concludes that "a bare right measured by production does not constitute an economic interest. This is made clear by what is said by the Supreme Court in Palmer v. Bender, 287 U.S. 551, 53 S. Ct. 225, 227, 77L. ed. 489, relied upon by petitioner." (260 F. 2d 337, 340.) In the Cox case the Fourth Circuit in discussing Remer makes note that it was decided basically upon the case of Helvering v. Elbe Oil Land Co., 303 U.S. 372 (1938). The Fourth Circuit states that the Remer and Elbe decisions are limited to their facts, but their facts seem to be similar or identical to the facts in petitioners' case.

(b) The case of Helvering v. Elbe Oil Land Co , 303 U.S. 372 (1938) has been discussed in many, many cases since its decision in 1938 and most courts, with the exception of Remer choose to distinguish or completely ignor that decision. It has been distinguished so many times that no one knows with any certainty the principal for which it stands and it is time for this court to either reverse or explain the Elbe decision.

(c) The state of the law upon which the Fourth Circuit rendered its decision is so uncertain and so unclear that the Tenth Circuit in the case of United States v. White, 311 F. 2d 399 (1962) decided on December 31, 1962, that the position taken by the taxpayer in that case, which is similar or identical to the one taken by the petitioner Cox in this case, was correct and that the mere retention of an interest in production did not prevent an intended sale from being a sale. Five years later in the same case cited as 401 F. 2d 610 (1958) on September 30, 1968, the Tenth Circuit decided that their prior decision should be reversed.

(d) The fact that the circuits are in conflict and the fact that the present Supreme Court decisons do not present adequate guide lines for the courts to follow are not the more important reasons why this petition should be granted. The most important reason why this petition should be granted is that by lower court interpretations over a period of the last fifteen years, there has been developed

a new principle of taxation which is in direct conflict with the principles and standards set up by the Supreme Court in their original rulings with regard to capital gain vs. depletion in the oil and gas field. The first White decision above referred to is a good example of why this writ should be granted. It was clear to the court in White that the taxpayer intended to make a sale; that the buyer intended to buy; that the asset was held over a period of six months; that it was a capital asset; and clearly entitled to capital gain treatment. The capital gain theory of taxation was established by the Congress for the purpose of giving tax relief in such a transaction as was involved in the White case and involved in petitioner's case. It was intended to protect the seller from incurring a burdensome tax debt when he disposed of a capital asset. The decision of the Fourth Circuit defeats the very purpose of capital gain concept. The later White case and petitioner's case now make it impossible for any taxpayer to sell anything less than 100% of his interests in oil and gas. Both cases conclude that if you sell less than 100%, you have retained an economic interest and if you retain an economic interest you must report the income for depletion and treat the sale price as bonus. This means that by judicial decision, the courts have taken from an individual his right to sell anything less than 100% of his interest in oil and gas or other depletable materials. The Internal Revenue Code does not contain any such provision. The courts have worked their way to this conclusion over a number of years because

they have not had adequate direction from the United States Supreme Court in their interpretation of the economic interest concept. This Court needs to speak out on explaining the economic interest concept and explain that portion of the economic interest concept dealing with the seller looking to the return of his investment from the interest which he retains. The economic interest concept is based upon the case of Palmer vs. Bender 287 U.S. 551 (1933), which is a correct statement of the law, but which has been improperly interpreted because of the position maintained by the Internal Revenue Service.

Wherefore, petitioner prays that a Writ of Certiorari be issued.

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APPENDIX

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF WEST VIRGINIA

JAMES T. COX,
Plaintiff,

vs. Civil Action
No. 68-102-E

UNITED STATES OF AMERICA
Defendant.

O R D E R

It appearing to the Court from the mandate of the United States Court of Appeals for the Fourth Circuit that the above styled civil action has been remanded to this Court for further proceedings, it is

ORDERED that this action be, and the same is hereby reopened and restored to the active docket of this Court.

In accordance with the mandate of the United States Court of Appeals for the Fourth Circuit and its opinion, Cox v. United States of America, No. 73, 2322 (4th Cir. May 22, 1974), directing this Court to enter judgment in favor of the defendant, it is

ADJUDGED and ORDERED that the plaintiff take nothing, and that this action be, and the same is hereby dismissed and stricken from the docket.

ENTER: June 14th, 1974.

/s/ Robert E. Maxwell
United States District
Judge

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF WEST VIRGINIA

JAMES T. COX,
Plaintiff,

vs. Civil Action No. 68-102-E

UNITED STATES OF AMERICA,
Defendant.

MEMORANDUM ORDER

This is a civil action authorized under 28 U.S.C. Sec. 1346 (a) and instituted by the Plaintiff-Taxpayer, James T. Cox (hereinafter referred to as Taxpayer), for the recovery of federal income taxes, allegedly overpaid for the calendar years 1963 and 1964. On April 22, 1968, the Commissioner of Internal Revenue established his position on the issues presented in this litigation by disallowing taxpayer's claims for refund.

The facts are undisputed in this litigation and have been stipulated by the parties in the pre-trial order submitted by counsel.

Succinctly stated, the facts are that in 1959, one A. T. Carr of Chesterville, Ohio, secured leases of 1,194 acres of oil and gas lands in New Milton and Cove Districts of Doddridge County, West Virginia. Mr. Carr's initial investment in this venture was $1,194.00, or $1.00 per acre.

Sometime in 1959 or 1960, Mr. Carr and the Taxpayer, a resident of this judicial district, whose principal occu-

pation is the operation of his own furniture store, entered into an informal partnership agreement whereby Taxpayer contributed $2,000.00 toward the development of one of the leases in exchange for a half interest in all the leases. The Carr-Cox partnership agreement was formalized in writing in 1963.

Following a successful drilling operation by an independent developer on adjacent land, the Carr-Cox partnership (hereinafter referred to as Partnership) assigned ten leases to various individuals and companies. Pursuant to these assignments the Partnership retained a 1/16th overriding royalty interest of the 7/8th working interest in each of the ten leasehold assignments. Thus, each partner's retained share amounted to a 1/32nd overriding royalty interest in the ten leases. In addition to the 1/16th overriding royalty interest, there was the further retention by the Partnership in one lease of a 1/4th working interest, subject to the reserved overriding royalty interest, of the 7/8ths working interest, or a 1/8th working interest as to each partner.

The initial proceeds from these assignments, $180,125.00 in 1963 and $115,000.00 in 1964, were equally divided by the two partners. On his federal income tax returns for 1963 and 1964, Taxpayer treated his share of the profits as long-term capital gains.

The Commissioner of Internal Revenue determined that the income from the assignments constituted ordinary income and assessed deficiencies in the amount of $12,156.17, plus $1,776.72

interest for the tax year 1963, and $5,556.63, plus $478.70 interest for the tax year 1964.

Taxpayer paid the assessed amounts with interest and filed a claim for a refund, which was disallowed by the Commissioner. Taxpayer then instituted this action seeking recovery of the amounts paid plus interest from October 8, 1966. Following a hearing in this matter the case was submitted to the Court on briefs, the pre-trial order and oral argument of counsel.

The issue presently before this Court is whether the retention by the Partnership of the overriding royalty interests, and the additional retention of a working interest as to one assignment, prevents the transactions from being a "sale or exchange" under Section 1222(3) of the Internal Revenue Code and thereby foreclosing long term capital gain treatment of the proceeds of the disposition.

The well recognized term, "Long-Term Capital gain" is defined by Section 1222(3) of the Internal Revenue Code [26 U.S.C. Sec. 1222(3)] as the

> gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income. (emphasis added).

The purpose of the capital gains provisions is to:

> relieve the taxpayer from ... excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions.

Burnet v. Harmel, 287 U.S. 103, 106 (1932).

There is no dispute as to the nature of the interests transferred by the Partnership in this case. The Commissioner agrees that the leases involved herein constitute a capital asset and further that they were held by the Partnership for more than 6 months.

In disallowing capital gain treatment, however, the Commissioner determined that the transactions were not "sales or exchanges" as contemplated by Sec. 1222 (3) in that the Partnership, in reserving overriding royalty interests, and an additional working interest, had retained an economic interest in the gas in place. The initial proceeds from the transactions were considered to be bonus payments, taxable as ordinary income subject to the statutory depletion deduction, or depletion allowance as it is sometimes referred to.

The crux of the Commissioner's position in the present case centers around the phrase "economic interest," a term first employed by the United States Supreme Court in Palmer v. Bender, 287 U.S. 551 (1933).

In holding that the retention of an economic interest was required before a taxpayer was entitled to a depletion

deduction the Court in Palmer stated:

> The language of the statute now [Sec. 611 of the Internal Revenue Code] is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital.

287 U.S. at 557.

This language was incorporated almost verbatim into Sec. 1.611-1(b) (1) of the Treasury Regulations which provides:

> (b) Economic interest. (1) Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits or standing timber. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital ...

Thus, the language from Palmer has become the guide in determining the appropriateness of a depletion deduction. Moreover, the Commissioner asserts that this same criteria should be applied in determining whether certain proceeds

are taxable as ordinary income or should receive capital gains treatment. The Commissioner's reasoning is that the tax concepts of a depletion deduction and long-term capital gains are mutually exclusive since the retention of an economic interest in a capital asset precludes the taxpayer from treating the transaction as a sale.

The Commissioner maintains that the Taxpayer here has retained an economic interest and that he is therefore entitled to a depletion deduction and not capital gains treatment.

The Taxpayer, on the other hand, argues that the Partnership intended to complete, and in fact did complete, the sale of a fractional interest in the leasehold estate. Helvering v. Elbe Oil Land Development Co., 303 U.S. 372 (1938), is cited for Taxpayer's proposition that "[t]he mere retention of an interest in an oil and gas lease does not by itself keep a sale from being a sale."

The Taxpayer relies on the terms of the agreements as evidence of a sale. The granting clause in each of the ten instruments, as it is included in the pre-trial order, provides:

> Assignor [Cox-Carr partnership], subject to the reservations, exceptions, terms and conditions herein contained, grant, sell, convey, assign, transfer, and set over unto the said Assignee [name], all that certain leasehold estate, consisting of [X] acres.

Likewise, the Taxpayer emphasizes the absence of any provisions requiring the assignees to develop the leasehold estates and the absence of any provisions allowing for a possibility of reverter.

The Taxpayer calls to the Court's attention that the amounts received by the partnership in exchange for the leasehold estates greatly exceeded the Partnership's investment. He also submits in effect that the retained interest in this case is too insignificant to "taint" the validity of the sale and the Commissioner's position would unjustifiably deprive the Taxpayer of the benefits of long-term capital gains treatment.

In the analysis of a business transaction, it is recognized that the substance, and not the form, governs the tax consequences of that transaction. Oliver v. United States, 408 F. 2d 769 (4th Cir. 1969). Difficulty is experienced in determining tax consequences, however, when the economic interest test is applied to transactions, such as are involved in this litigation, which possess some traditional characteristics of both sales and leases.

But in the law of conveyances and contracts, oil and gas leases and attendant documents, have been set apart. Because of the complicated challenges of drilling for and then controlling the "captured" oil and gas, the historic view of mining laws was not adequate and the courts and legislatures developed new concepts based on prevailing law.

In addition to a sizeable use of expressed or implied promises to explore

and develop leased property, oil and gas leases are now established in law as creating fixed terms of property interest. They also define the obligations assumed by the parties, especially the lessee.

One of the notable variables usually found in oil and gas leases is the right of the lessee to assign his interest to another. This is a necessary right in the practical business world of the oil and gas industry. The banking industry requires of its most responsible customers, that they employ commercial leases as collateral for borrowing operating or working assets.

Also, in an effort to obtain venture capital from third parties, assignments of fractional interests are an accepted business practice to defray the high costs of drilling.

Purchases through assignment of fractional interests in mineral estates thus become a valid method of ownership, a capital asset. This method of transfer of mineral estates is binding, and additionally are recognized today as equitable working contracts and undertakings between the parties.

Here we do not have the situation where an operator is raising finances to develop and explore for oil and gas. But the principle of divisibility of ownership of real estate-mineral interest remains.

The interest retained here, as a result of the assignments, would appear

to bear the characteristics of as absolute, sovereign, independent partition of ownership. The retained interests reflect a self-contained, autonomous state that responds and develops independent of the whole. Thus, it becomes critically important to measure the issues presented here against the acceptability of such transactions in the oil and gas industry. It is by this evaluation that we can truly and factually "look to the substance of the transaction."

The second aspect of the economic interest test requires "income derived from the extraction of the mineral ... to which he [the taxpayer] must look for a return of his capital." (emphasis added). As pointed out by the Taxpayer, however, the initial payments to the Partnership, which were not dependent upon production, exceeded the original expenditures and the Partnership recouped its capital investment at the outset. Viewed in a realistic light, the Partnership, after the assignments in issue, no longer looked to the production of the gas for a return of its capital and, as a result, the Partnership no longer concerned itself with the risks of production of the gas.

The recoupment of the initial investment, the corresponding absence of an element of risk-sharing and the lack of obligatory provisions regarding production are persuasive that the Commissioner's position in the present case is too broad. This Court is satisfied that the transfer of the Partnership's interest constituted a sale or exchange. Helvering

v. Elbe Oil Land Development Co., supra; Commissioner v. Remer, 260 F. 2d 337 (8th Cir. 1958).

Brinkley v. United States, 340 F. Supp. 417 (E.D.VA. 1972), presents a representational case where the parties entered into a contract involving "the mineral estate herein agreed to be purchased and sold" and which materially reflects a retained economic interest, thus depriving the sellers of capital gains treatment of the proceeds of the transaction. Under the facts of Brinkley, and particularly the terms of the contract under review, Brinkley's monetary receipts were "concretely linked" and dependent upon production. Under the facts of Brinkley it was the extraction of minerals that secured the return of capital.

It would be an unwarranted extension of the principles, applied in Palmer, Oliver and Brinkley, to link here the separate, distinct, divisible mineral estates and to find or suggest that the possibility of future production, within the entire estate, involving the several part owners, thus destroys Taxpayer's capital gains position.

Consequently, the Taxpayer was correct in treating the proceeds as capital gains and he is entitled to the relief which he seeks in this action, and an appropriate order consistent with the reasons and conclusions above stated will be entered.

ENTER: June 4th, 1973.

/s/ Robert E. Maxwell
United States District Judge

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 73-2322

JAMES T. COX, Appellee,

versus

UNITED STATES OF AMERICA, Appellant.

Appeal from the United States District Court for the Northern District of West Virginia, at Elkins. Robert E. Maxwell, Chief Judge.

Argued March 6, 1974 Decided May 22, 1974

Before WINTER, BUTZNER and FIELD, Circuit Judges.

William S. Estabrook, III, Attorney, Tax Division, United States Department of Justice, (Scott P. Crampton, Assistant Attorney General, Meyer Rothwacks and Grant W. Wiprud, Attorneys, Tax Division, United States Department of Justice, James F. Companion, United States Attorney, on brief) for Appellant; Boyd L. Warner (Stathers and Cantrall on brief) for Appellee.

FIELD, Circuit Judge:

This appeal presents the question whether the retention of an overriding royalty interest incident to the assignment of certain oil and gas leases constitutes an "economic interest" which subjects the initial lump sum payments to ordinary income treatment rather than capital gains consideration.

In 1959 A. T. Carr leased 1,194 acres of oil and gas lands in Doddridge County, West Virginia, for one dollar per acre. In 1960 the appellee, James T. Cox, entered into an informal agreement with Carr under which he would contribute $2,000 for the development of a well in exchange for a half interest in all of the leases. Spurred by successful drilling operations on adjacent land, the partnership assigned ten leases to various companies for $180,125 in 1963 and $115,000 in 1964. Cox and Carr shared the proceeds equally, and the partnership retained a 1/16th overriding royalty interest[1] of the 7/8th

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1. A royalty interest is a right to receive a specified percentage of all oil and gas produced during the lease. 3B Mertens, Law of Federal Income Taxation, Sec.22.37 at 329 (1973). If the owner of an oil and gas lease transfers it to another operator, retaining a share of the production, ususally 1/16th, free of expense other than severance tax, this retained interest is called an overriding royalty. It differs from a landowner's royalty in that it stems from the lease and terminates with the lease. Acquisition of Oil and Gas Properties, 21 Oil & Gas Tax Q. 1, 10 (L. Fiske ed. 1972).

working interest[2] in each of the ten leasehold assignments. Additionally, the partnership retained a 1/4th working interest, subject to the reserved overriding royalty interest, in one lease.

Cox treated his share of the profits as a long-term capital gain on his 1963 and 1964 tax returns. The Commissioner of Internal Revenue viewed the profits as ordinary income subject to a depletion allowance and assessed deficiencies of $12,156.17 plus $1,776.72 interest for 1963 and $5,556.63 plus $478.70 interest for 1964. Cox paid the deficiencies and sought a refund which was denied. He then instituted this action pursuant to 28 U.S.C. Sec. 1346 (a) (1) for recovery of the alleged overpayment. The district court granted judgment in favor of Cox and the government appeals.

The test for determining what is an economic interest first appeared in Palmer v. Bender, 287 U.S. 551 (1933), and is now found in Treas, Reg. Sec. 1.611-1 (b) (1) (1960):

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2. An oil and gas lease ordinarily conveys the entire mineral interest less any royalty interest retained by the lessor. The owner of the lease is said to own the "working interest" because he has the right to develop and produce the minerals. Commissioner v. P. G. Lake, Inc., 356 U.S. 260, 261 n. 1 (1958).

"An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place * * * and secures, by any form of legal relationship, income derived from the extraction of the mineral * * * to which he must look for a return of his capital."

The district court held the lump sum payments were subject to capital gains treatment because they were not dependent upon the extraction or production of oil and therefore did not fall within the scope of the treasury regulation. The record, however, does not support this bifurcated view of the transaction. Each of the ten leases assigned by the partnership is inextricably bound by a reserve clause which grants the partnership a 1/16th overriding royalty interest, and in one of the ten leases, a 1/4th working interest, subject to the reserved overriding royalty interest of the 7/8th working interest. Accordingly, income from the royalty interests is tied directly to oil and gas production.

Assuming, however, that the two lump sum payments here in question were independent of the retained royalty interests, substantial authority denies them the benefit of capital gain treatment. In Burnet v. Harmel, 287 U.S. 103 (1932), the issue was whether a lump sum bonus paid the lessor under an oil and gas lease, which reserved the usual royalty, was to be treated as capital gain or ordinary income. The Court put all portions of the transaction into one

category, viewing the bonus as anticipatory royalty which should be treated as ordinary income. In Herring v. Commissioner, 293 U.S. 322 (1934), the Court held that the depletion allowance was applicable to advance royalties and bonuses received by a lessor upon the execution of an oil and gas lease even though there were no wells on the property and no production during the taxable year. Finally, in Commissioner v. P. G. Lake, Inc., 356 U. S. 260 (1958), the Court decided that the consideration received for the assignment of an "oil payment right" carved out of a larger mineral interest (whether a royalty interest or a working interest) was taxable as ordinary income, subject to a depletion deduction, and not as a capital gain. The Court reasoned that "[t]he lump sum consideration seems essentially a substitute for what would otherwise be received at a future time as ordinary income." 356 U.S., supra, at 265.

In reaching the conclusion that Cox did not retain an economic interest the court below made no reference to the foregoing decisions, but relied primarily on Helvering v. Elbe Oil Land Co., 303 U. S. 372 (1938), and Commissioner v. Remer, 260 F. 2d 337 (8 Cir. 1958). We find, however, that Elbe has been considerably diluted by subsequent decisions and is of little precedential persuasiveness. In Elbe, the taxpayer sold all of its interest in certain oil and gas properties in consideration of a large initial lump sum payment, four substantial deferred payments which were payable without regard to production,

and a residual interest in the net profits from production and operation of the properties.[3] The Court denied the taxpayer a depletion deduction computed on the cash payments, holding that the transaction was an absolute sale of the taxpayer's interest in the property. With reference to the taxpayer's participation in the net profits, the Court stated that it was "unable to conclude that the provision for this additional payment qualified in any way the effect of the transaction as an absolute sale or was other than a personal covenant of the [purchaser]." 303 U.S., supra, at 375.

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3. A net profits interest is a share of gross production measured by net profits from operation of the property. Like the overriding royalty it is created from the working interest, and the net profits interest differs from other production-measured payments in that it represents a fractional share of the profit of the operating company, rather than a fractional share of the minerals themselves as produced. Comment, Sale or Lease: Capital Gain or Ordinary Income Subject to Depletion in Mineral Transactions, 32 LA. L. Rev. 417, 424 n. 30, (1972).

Eight years after Elbe, in Burton-Sutton Oil Co., Inc. v. Commissioner of Internal Revenue, 328 U. S. 25 (1946), the Court concluded that where the assignor of certain oil rights retained an interest in the net operating profits, the transaction was not a sale but rather an assignment "with a reservation in the assignor of an economic interest in the oil." Id., at 37. The Court attempted to distinguish rather than overrule its decision in Elbe, concluding that "the holding of Elbe should not be extended to the facts of this agreement." Id., at 36.[4] In Commissioner of Internal Revenue v. Southwest Exploration Co., 350 U. S. 308 (1956), the Court again declined to follow Elbe, holding that the retention of a share of net profits was an economic interest in the oil in place which entitled the taxpayer to the depletion allowance. The moribund state of Elbe was recognized by the Tenth Circuit in Commissioner of Internal Revenue v. Pickard, 401 F. 2d 615 (1968), with the observation that "[t]he Supreme Court in Burton-Sutton appears to have limited Elbe to its particular facts, as did Comm'r v. Southwest Exploration Co. * * *." Id., at 616.

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4. In a separate opinion, Mr. Justice Frankfurter criticized the "gossamer" distinctions drawn by the majority between Elbe and Burton-Sutton, "which hardly can be held in the mind longer than it takes to state them * * *." 328 U. S. at 38.

Similarly, the Eighth Circuit's decision in Commissioner v. Remer, supra, which involved the sale of "stockpiled iron ore mining leases" and was decided largely on the basis of Elbe, has been limited to its particular facts. See Wood v. United States, 377 F. 2d 300 (5 Cir.), cert. denied 389 U. S. 977 (1967); Rabiner v. Bacon, 373 F. 2d 537 (8 Cir. 1967).

To accept the taxpayer's contention that the reserve clause should be divorced from the alleged fractional sale of a capital asset would place us in the situation which confronted the Tenth Circuit in United States v. White, 311 F. 2d 399 (1962), overruled 401 F. 2d 610 (10 Cir. 1968). In White the taxpayers received a payment of $175,000 plus a ten per cent royalty of the gross value of all uranium mined from the property. In its initial opinion the court held that the lump sum payment was part of the consideration paid for the sale of the minerals and was properly treated as a capital gain since the taxpayers had retained no economic interest in the minerals in place. Six years later the same taxpayers sought to have the royalty payments taxed at capital gain rates rather than ordinary income. Sitting in banc, the court found that the absence of a total price plus the continued participation by the taxpayers in the mineral production made the transaction a lease and not a sale thereby subjecting the royalty payments to ordinary income treatment. In overruling its prior decision the court stated:

"As will be hereinafter developed the transaction must be examined as a whole and, under the decisions of the Supreme Court, put into one category. It is tempting to divide the transaction into several steps with different tax consequences, but this cannot be done. The tax category into which the entire transaction must be placed is that of a lease."
401 F. 2d, supra, at 611.

We conclude that in the transactions before us Cox retained an economic interest in the oil and gas which requires that the lump sum payments be taxed as ordinary income subject to the depletion allowance and not as capital gains. Accordingly, the judgment of the district court is reversed and the case remanded with instructions to enter judgment in favor of the government.

REVERSED and REMANDED.

In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-144

JAMES T. COX, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

The sole issue raised by the petition is whether a lump sum payment received in consideration for an assignment of an interest in oil and gas leases is taxable as ordinary gain, where the recipient of the payment retains a royalty interest in the transferred lease interests.

Petitioner and A.T. Carr held equal partnership interests in leases covering oil and gas lands in Doddridge County, West Virginia, in which petitioner had invested $2,000. Following a successful drilling operation on adjacent land, the partnership assigned ten leases to various companies for lump sum down payments totaling $295,-125. However, the partnership retained a one-sixteenth overriding royalty interest of the seven-eighths working interest in each of the ten leasehold assignments. In addition, the partnership retained a one-quarter working interest in one lease, subject to the reserved overriding royalty interest (Pet. App.).

Petitioner reported his share of the lump sum payments as long-term capital gain. On audit, the Commissioner determined that the payments were ordinary income from leases which were subject to the allowance for depletion, because petitioner's retention of royalty interests in the transferred leases constituted an "economic interest." The district court upheld petitioner's contention that the payments were taxable as capital gain. The court of appeals reversed, holding that the lump sum payments were depletable advance royalties because petitioner had retained an economic interest in the leaseholds by reserving a one-sixteenth overriding royalty interest in the ten leases, and a one-quarter working interest in the seven-eighths working interest in one lease (Pet. App.).

1. Section 611(a) of the Internal Revenue Code of 1954 allows as a deduction in computing taxable income from mineral deposits "a reasonable allowance for depletion * * *." This case presents the frequently litigated question whether the consideration received by a transferor of mineral rights is taxable as ordinary income subject to the depletion allowance from a form of lease or capital gain from a sale. The decisions of this Court have long established that the controlling test is whether the transferor has retained an "economic interest" in the minerals in place. If the transferor retains such an interest, the consideration he receives is taxable as ordinary income subject to the depletion allowance. See *e.g., Palmer* v. *Bender*, 287 U.S. 551; *Herring* v. *Commissioner*, 293 U.S. 322; *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25.

The court of appeals correctly concluded that petitioner's royalty interests were retained "economic interests" in the oil in place so that all income from the leases, including the lump sum down payment at issue, was

taxable as ordinary income subject to the depletion allowance and not as capital gain from a sale. The definition of "economic interest" in *Palmer* v. *Bender, supra,* 287 U.S. at 557, has been incorporated in Treasury Regulations, Section 1.611-1(b)(1), which provide as follows:

> An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place * * * and secures, by any form of legal relationship, income derived from the extraction of the mineral * * *, to which he must look for a return of his capital.

In *Palmer,* the Court held that a lessee of oil and gas properties which assigned its interest for a future cash bonus "to be made 'out of one-half of the first oil produced and saved' to the extent of $1,000,000, and an additional 'excess royalty' of one-eighth of all the oil produced and saved" (287 U.S. at 553-554), was ordinary income entitled to the depletion allowance on the bonus and royalties received in the taxable year because the bonus was a return of the lessee's capital investment in the mineral in anticipation of its extraction.

Applying the "economic interest" concept to the facts of this case, the court of appeals correctly characterized petitioner's retention of a right to a specified percentage of the proceeds of sale from the minerals produced from the transferred leaseholds as a retained economic interest. See *e.g., Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260, 261, n. 1; *Anderson* v. *Helvering*, 310 U.S. 404, 409. The lump sum down payment was not the proceeds of a sale, taxable as capital gains. To the contrary, it was an advance royalty or bonus which constitutes depletable ordinary income regardless of the form of the conveyance or whether production has begun in the year of the receipt.

Burnet v. *Harmel*, 287 U.S. 103; *Herring* v. *Commissioner, supra; Burton-Sutton Oil Co.* v. *Comissioner, supra; United States* v. *White*, 401 F. 2d 610 (C.A. 10).[1] See also *Douglas* v. *Commissioner*, 322 U.S. 275.

2. Contrary to petitioner's contention (Pet. 9-10), the decision below does not conflict with either *Helvering* v. *Elbe Oil Land Co.*, 303 U.S. 372, or *Commissioner* v. *Remer*, 260 F. 2d 337 (C.A. 8). In *Elbe Oil*, the taxpayer transferred mineral rights for a cash down payment and four deferred payments totalling $2,000,000. After the purchaser had recouped its expenditures of acquisition, development and operation, the taxpayer was to receive monthly one-third of the venture's net profits. The contract specified that the parties intended that full ownership, title and possession vest in the purchaser. On those facts, the Court held that an absolute sale was intended and accomplished, and that the seller was not entitled to depletion on the cash consideration received. Subsequently, the Court held in *Burton-Sutton Oil Co.* v. *Commissioner, supra,* that the retention of a net profits interest was the retention of an economic interest, precluding characterization of the transaction as a sale. In discussing the prior *Elbe Oil* decision, the Court noted that the deferred payments in that case were not payable out of oil sales but were payable absolutely, unless there

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[1] In *United States* v. *White*, 311 F. 2d 399, the Tenth Circuit originally held that in a conveyance of mineral rights for a lump sum of $175,000 and a retained royalty, the lump sum was the proceeds of a sale and taxable at capital gains rates. However, in *United States* v. *White*, 401 F. 2d 610, that court, when confronted by the question of the tax treatment of amounts received by the same taxpayers with respect to their retained royalty interest, overruled its earlier decision and held that both the lump sum payment and the royalties were depletable ordinary income because of taxpayer's retention of an economic interest in the form of royalties.

was an abandonment. As a result, the Court declared that "the holding of *Elbe* should not be extended to the facts of [the *Burton-Sutton*] agreement" (328 U.S. at 36). See also *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308, 314, where the Court similarly distinguised *Elbe Oil.*

In like manner, *Commissioner* v. *Remer, supra*, which relied upon *Elbe Oil*, has been distinguished by a subsequent decision of that court. See *Rabiner* v. *Bacon*, 373 F. 2d 537, 539 (C.A. 8). Accord: *Commission* v. *Pickard*, 401 F. 2d 615, 616 (C.A. 10); *Wood* v. *United States*, 377 F. 2d 300, 308 (C.A. 5), certiorari denied, 389 U.S. 977. Thus, to the extent that *Elbe Oil* and *Remer* have any continuing vitality, it is only with respect to their particular facts. They in no way limit the subsequent holdings of this Court in *Burton-Sutton Oil* and its progeny, which are fully applicable here, that a royalty interest is a retained economic interest in the mineral in place.

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

NOVEMBER 1974.

DOJ-1974-11